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Tax Tips for Small Business Winter 2009/2010

Employee or Independent Contractor?

Determining the proper worker status

When you hire someone to work in your business, that individual will either be an employee or independent contractor for tax purposes. Failure to properly classify the worker can subject you to an IRS audit and possibly interest and penalties for failing to withhold and deposit payroll taxes. Under common-law rules, if you have control over what work is being done and how it will be done, you are generally regarded as an employer and the worker is considered your employee.

The IRS uses three factors to determine the proper worker classification. Behavioral control refers to facts that show whether there is a right to direct or control how the worker does the work. Behavioral control looks at the type of instruction given, the degree of instruction, an evaluation system, and training.

The second factor is financial control. Financial control refers to facts that show whether or not the business has the right to control the economic aspects of the worker's job. Financial control factors consist of significant investment, unreimbursed expenses, opportunity for profit or loss, services available to the market, and method of payment. If you provide the tools and supplies to do the job, set the work hours, provide the location where the work is performed,

and can hire or fire the worker, chances are this worker is classified as an employee. However, if the worker provides his own tools and supplies, performs services for an agreed price, performs these same services to others, and maintains control over how the work is completed, the worker is more likely an independent contractor.

The third factor is the type of relationship between you and the worker. Under type of relationship, take into consideration any written contracts, employee benefits, permanency of the relationship, and services provided as the key activity of the business. An employee will be hired for a long-term relationship and employee benefits will generally be provided.

You must weigh all of these factors when determining whether a worker is an employee or independent contractor. Some factors may indicate that the worker is an employee, while other factors indicate an independent contractor. The key is to look at the entire relationship you have with the worker, consider the degree or extent of the right to direct or control, and finally document each of the factors used in arriving at a determination.

If you are unsure whether your newly hired worker is an employee or independent contractor, you may file Form SS-8 with the IRS. They will assist you in making a proper determination, thus avoiding mistakes, audits, and additional taxes and penalties.

New Forms to Correct Employment Returns

Do you need to make an adjustment?

The IRS has released the following new forms:

- Form 941-X, Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund, used to correct errors on Forms 941 and 941-SS. Form 941c can no longer be used.
- Form 943-X, Adjusted Employer's Annual Federal Tax Return for Agricultural Employees or Claim for Refund, used to correct errors on Form 943.
- Form 944-X, Adjusted Employer's Annual Federal Tax Return or Claim for Refund, used to correct errors on Forms 944 and 944-SS.
- Form 945-X, Adjusted Annual Return of Withheld Federal Income Tax or Claim for Refund, used for adjusting prior filed employment forms and to fix errors on Form 945.

Qualified Transportation Fringe Benefits

New bicycle commuting reimbursement for 2009

The value of qualified transportation fringe benefits you pay to your employee is generally excluded from the employee's wages for 2009 up to certain limits. For commuter highway vehicle transportation and transit passes paid during January and February 2009, the limit is \$120 per month. The amount increased to \$230 a month on March 1, 2009. Qualified parking is \$230 per month. For each calendar year, \$20 multiplied by the number of qualified bicycle commuting months during the year is the qualified bicycling commuting reimbursement.

A qualified bicycle commuting month is defined as any month the employee regularly uses a bicycle for a substantial portion of the travel between the employee's residence and their work place. The employee cannot receive any

other transportation fringe benefits during these months.

The employee can be reimbursed for the purchase of the bicycle and bicycle improvements, repairs, and storage. These expenses are considered reasonable as long as the bicycle is regularly used as transportation between the employee's residence and work place.

Employer-Provided Educational Assistance

Giving back to your employees

You can provide your employees with tax-free education assistance by offering an educational assistance program. This allows you to provide up to \$5,250 for tuition, fees, books, and supplies for classes without having to include the amount in an employee's wages. Both undergraduate and graduate level courses qualify for the assistance. The classes need not be job-related to qualify.

Choosing the §179 Expense Deduction

Take advantage of year-end equipment purchases

Each year, the IRS allows a business to write off the cost of purchased equipment. For 2009, the maximum amount allowed is \$250,000. The equipment can be purchased and placed in service at any time during the tax year. Even if you wait until the last day of the year to purchase and place in service a piece of equipment, you are allowed the full \$250,000 deduction.

The \$250,000 maximum is reduced dollar-for-dollar if your asset purchases exceed \$800,000. This means that if you purchase \$1,050,000 of eligible §179 properties during 2009, no deduction is allowed. Another limitation is that the §179 deduction cannot exceed your taxable business income. Business income includes the income from your

trade or business plus wages received by you or your spouse, if married filing jointly.

Going Out of Business?

Know the tax consequences before closing your doors

You can close your business by selling all of the assets or converting the assets to personal use. The tax consequences of selling your business depend on whether you are operating a sole proprietorship or corporation. As a sole proprietor, if you sell all the assets of your business, you report the sale of each asset separately to determine the gain or loss. If you close your sole proprietorship business and keep all the assets to use personally, there may be some tax on recapture of depreciation.

When you want to end your corporate business, you can either sell the stock or the assets. If the assets are sold, the corporation pays the tax on any gain. As the shareholder, you don't have any tax consequences unless the corporation liquidates and distributes the proceeds to you in exchange for your stock. If the stock is sold, you report the sale of your corporate stock on your personal tax return.

If you take the assets out of the corporation, gain or loss is recognized on the liquidating distribution of assets as if the corporation sold the assets to you at fair market value. You, as the shareholder, do not have any tax consequences unless the fair market value of the assets distributed exceeds your stock basis.

As with any sales contract, it's important to determine the tax consequences before signing on the dotted line.

Health Savings Accounts (HSAs)

What are the employer contribution limits for 2009?

An HSA is a tax-exempt custodial account set up to pay or reimburse your medical expenses incurred during the year. The HSA is set up with a qualified HSA trustee. Eligible individuals must: (1) be covered under a high deductible health plan (HDHP) on the first day of the month, (2) have no other health coverage, (3) not be enrolled in Medicare, and (4) not be claimed as a dependent on someone else's tax return.

The amount that you can contribute to an HSA depends on your type of HDHP, age, and date of eligibility. The date you are no longer eligible must also be considered if applicable. Employers can contribute up to a specified dollar limit, which is exempt from federal income tax withholding, social security tax, Medicare tax, and FUTA tax. For 2009, the employer can contribute up to \$3,000 (\$4,000 if age 55 or older) if you have self-only coverage under a HDHP or up to \$5,905 (\$6,950 if age 55 or older) if you have family coverage under an HDHP.

Business Credits

You could be eligible

Business owners are eligible for a variety of tax credits. Here are a few credits you may qualify for:

- Alcohol Cellulosic Biofuel Fuels Credit. This credit varies depending on the alcohol proof percentage and the type of alcohol.
- Alternative Motor Vehicle Credit. This credit is available for certain new vehicles purchased and placed in service for business use during the tax year. There are five components to this credit.
 - (1) Qualified fuel cell motor vehicle credit;
 - (2) Advanced lean burn technology motor vehicle credit;
 - (3) Qualified hybrid motor vehicle credit;
 - (4) Qualified alternative fuel motor vehicle credit; and
 - (5) Plug-in conversion credit.

- **Alternative Fuel Vehicle Refueling Property Credit.** This credit has been increased to 50 percent of the cost of qualifying property up to \$50,000 per location (\$200,000 for hydrogen).
- **Disabled Access Credit.** This credit amount equals 50 percent of the eligible access expenditures for the tax year between \$250 and \$10,250, with a maximum credit of \$5,000.
- **Employer Provided Child Care Credit.** Employers who provide in-house child care for their employees' children qualify for this credit. The credit cannot exceed \$150,000 for the year.
- **Small Employer Pension Plan Start-Up Cost Credit.** This 50-percent credit applies to the first \$1,000 in administrative expenses over the first three years to set up an employer pension plan and is limited to \$500 per year.
- **Tip Credit.** This credit is determined based on the federal minimum wage per hour rate. It is equal to 7.65 percent of the tips in excess of the amount needed to make up the minimum wage rate level. If the tip credit is claimed, the related social security taxes cannot be deducted.

Compensating an S Corporation Shareholder

What is considered reasonable?

If you are a corporate officer of an S corporation performing services for the corporation, you must pay yourself a reasonable salary. The IRS has not defined reasonable compensation in the code or regulations. However various courts have ruled on this issue based on the facts and circumstances of each case. Some of the factors the courts look at to determine reasonable compensation include training and experience, duties and responsibilities, time and effort devoted to the business, dividend history, payments to non-shareholder employees, timing and manner of paying bonuses to key people, what comparable

businesses pay for similar services, compensation agreements, and the use of a formula to determine reasonable compensation. S corporations should not attempt to avoid paying employment taxes by having their officers treat their compensation as cash distributions, payments of personal expenses, and/or loans rather than as wages. The IRS could reclassify these amounts as compensation to the shareholder/employee resulting in additional taxes and penalties for the S corporation.

Keeping Good Records

Why it's important for your business

A business owner who keeps good records is able to easily monitor the progress of his or her business. Records can show whether the business is improving, what items are selling, or what changes may be necessary to make it more profitable. Keeping good records can increase any business owner's chances of success.

Records are needed to prepare your financial statements. Income statements and balance sheets are used to prepare your income tax returns. Saving your receipts makes it easy to keep track of which expenses are business-related and which ones are not. Keeping good records also helps you to distinguish between taxable and nontaxable income.

Keeping track of expenses lessens the chance that you'll forget which expenses need to be deducted when it comes time to prepare your tax return. Any record that supports the information reported on your tax return is a record worth saving. If the IRS audits your tax return, having a complete set of records for the year in question will speed up the examination process.

Quik Tips

1. The maximum depreciation deduction you can take for a truck or van used in business and first placed in service in 2009 is \$3,060 (\$11,060 for trucks and vans for which the special depreciation allowance applies).
2. Your employer contributions to a profit-sharing, SEP, or a SIMPLE plan are due by the time you file your tax return unless you have a valid extension. If your tax return is on extension, you have until the extended due date to make the contribution.
3. The maximum employee elective deferral amount for a §401(k) or §403(b) plan is \$16,500 for 2009.
4. Employers are required to issue W-2s to employees by January 31 of each year.
5. The standard mileage rate for business travel in 2009 is 55 cents per mile.
6. Are you giving gifts to your clients this holiday season? You are allowed a deduction for up to \$25 for each business-related gift.
7. The maximum amount of wages subject to social security for 2009 is \$106,800. There is no limit on the amount of wages subject to Medicare tax.
8. The 10-year rule for built-in gains tax on S corporations has been reduced to 7 years for tax years beginning in 2009 or 2010. This tax only applies to S corporations that used to be prior C corporations.
9. The exclusion for gain on the sale of qualified small business stock has increased to 75 percent for stock acquired after February 17, 2009, and before 2011.

The information contained in this newsletter is not intended to provide specific tax advice or to take the place of either the written law or regulations.

Hope you are enjoying the Fall season.

Kathleen A Scanlonkk